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FOREIGN SOURCE INCOME: PROBLEMS OF TAX RETURN NONFILING AND INCOME UNDERREPORTING BY AMERICANS LIVING OR INVESTING ABROAD

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FORTY-FOURTH REPORT

BY THE

COMMITTEE ON GOVERNMENT OPERATIONS

AUGUST 8, 1986.—Committed to the Committee of the Whole House on the the State of the Union and ordered to be printed

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LETTER OF TRANSMITTAL

HOUSE OF REPRESENTATIVES,
Washington, DC, August 8, 1986.

Hon. THOMAS P. O'NEILL, Jr.,
Speaker of the House of Representatives,
Washington, DC.

DEAR MR. SPEAKER: By direction of the Committee on Government Operations, I submit herewith the committee's forty-fourth report to the 99th Congress. The committee's report is based on a study made by its Commerce, Consumer, and Monetary Affairs Subcommittee.

JACK BROOKS, *Chairman.*

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99TH CONGRESS 2d Session | HOUSE OF REPRESENTATIVES | REPORT 99-770

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AUGUST 8, 1986.--Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. BROOKS, from the Committee on Government Operations, submitted the following

FORTY-FOURTH REPORT

BASED ON A STUDY BY THE COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE

On August 5, 1986, the Committee on Government Operations approved and adopted a report entitled "Foreign Source Income: Problems of Tax Return Nonfiling and Income Underreporting by Americans Living or Investing Abroad." The chairman was directed to transmit a copy to the Speaker of the House.

I. INTRODUCTION

> Mr. BARNARD. Mr. Finch, I think the sum and substance of all this is that if an American taxpayer wants to evade his tax obligations without drawing the ire of the IRS, does he have a significantly better chance if he lives overseas or otherwise earns his income from overseas sources?
>
> Mr. FINCH. (Associate Director, General Government Division, General Accounting Office). I think his odds are better; yes, sir.[1]

On May 8, 1985, the Commerce, Consumer, and Monetary Affairs Subcommittee held hearings to examine IRS' ability to assess taxes on income earned abroad by Americans—so-called foreign source

[1] "Problem of Tax Return Nonfiling by Americans Living Abroad," a hearing before the Commerce, Consumer, and Monetary Affairs Subcommittee of the Committee on Government Operations, U.S. House of Representative, May 8, 1985, p. 40 (hereafter referred to as "Hearing").

income.[2] The subcommittee studied two specific aspects of the foreign source income problem: First, the Internal Revenue Service's response to the problem of tax return nonfiling and income underreporting *by Americans living abroad;* and, second, weaknesses in the Foreign Income Information Returns Program (FIRP). Under this program, the competent tax authorities of certain foreign nations agree to send IRS available information on income earned in those nations *by U.S. taxpayers wherever they reside.*

Although this report examines tax evasion problems on income earned abroad by U.S. taxpayers, it does not address the use of tax haven/bank secrecy jurisdictions to hide income and carry out tax evasion schemes. Nor does it emphasize the loss of tax revenues on income generated in the underground economy. Rather, the report seeks to determine whether all foreign source income—simply as a byproduct of its being generated outside the United States—"enjoys" a degree of protection from discovery by the IRS comparable to that available through the use of secret accounts in tax haven nations.

Nearly 2 million Americans, not affiliated with our Armed Forces, reside abroad on a permanent or semipermanent basis.[3] Although the laws governing the ultimate taxability of their income are complex, two are of overriding importance: First, the United States taxes the worldwide income—both earned and investment—of its citizens wherever they live. Second, U.S. citizens living abroad are required to file income tax returns to the same extent as citizens residing in the United States. Although U.S. citizens living abroad may be entitled to certain tax advantages based on foreign residency, whether or not they have a tax liability is a judgment of the Internal Revenue Service and not the individual taxpayer. IRS cannot make that judgment unless the taxpayer files a return and documents supporting exclusions based on residency abroad.[4]

The General Accounting Office stated the obligation of U.S. citizens residing abroad to file returns and pay taxes in the following way:

> U.S. citizens residing abroad are generally required to file Federal income tax returns regardless of (1) foreign residency, (2) the type of income earned, (3) the amount of foreign taxes paid, or (4) the effect of the foreign earned income exclusion. This is so for a number of reasons. First, foreign residency alone does not exempt U.S. citizens from filing a U.S. tax return because * * * U.S. citizens are taxed based on citizenship, not residency. In addition, most types of income, including annuities and investment

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[2] Sections 861 and 862 of the Internal Revenue Code define which income is from sources "within" or "without" the United States.

[3] Based on State Department data from U.S. Foreign Service Posts, in 1983. According to the Department of Defense, approximately 880,000 military personnel and dependents resided in foreign countries as of September 1984.

[4] "U.S. citizens and resident aliens living or traveling outside the United States, generally, are required to file income tax returns, State tax returns, and gift tax returns, and pay estimated tax in the same way as those residing in the United States. If you are a U.S. citizen or a resident alien of the United States and living abroad, you are, in general, taxed on your worldwide income. However, you may qualify to exclude up to $80,000 of *earned* income in 1985 and, in addition, exclude or deduct certain foreign housing amounts."

income, are subject to tax. Second, in order to claim the foreign tax credit, IRS Form 1116 (Computation of Foreign Tax Credit) and sufficient proof that tax was paid to a foreign jurisdiction, must be filed along with the tax return. And third, in order to qualify for the foreign earned income exclusion a taxpayer must meet either a bona fide residence or physical presence test.[5]

This report also examines the effectiveness of IRS programs designed to identify and properly assess taxes on foreign source income earned by American taxpayers *who reside in the United States*. A particular focus of the report is the adequacy of the Foreign Information Returns Program (FIRP). Under this program, the tax authorities of our tax treaty partners agree to provide the Service with information documents reporting foreign source income earned by Americans. These foreign information reports are designed to function in much the same way as IRS' Domestic Income Information Returns (Forms W-2 and 1099) Document Matching Program: [6] The presence of a foreign information document and the absence of a corresponding tax return indicate a possible nonfiling problem. Similarly, the failure of a tax return to report income shown on a foreign information document indicates an underreporter problem.

The Foreign Information Reports Program lies at the heart of IRS' ability to detect nonfiling or underreporting by the millions of Americans who live abroad and by the millions more who live in the United States but have direct and portfolio investments abroad. IRS audit coverage is not even remotely adequate to assure tax compliance by the masses of taxpayers on their domestic or foreign source income. Only 1.3 percent of all individual tax returns, only

[5] Hearing, p. 29.

[6] IRS will match 90–95 percent of the 806 million domestic information documents reporting tax year 1985 income. By tax year 1990, IRS will be receiving in excess of 1 billion income information documents. The following income is subject to information reporting if paid by U.S. payers or by foreign payers engaged in a trade or business in the United States.

	Type of income or deduction	Amount to report
(1)	Wages, tips and other employee compensation	All amounts.
(2)	Sales of securities	All amounts.
(3)	Futures, commodities and bartering transactions	All amounts.
(4)	Fishing boat proceeds	All amounts.
(5)	Retirement payments (other than total distributions)	$10.00 or more.
(6)	Unemployment compensation	$10.00 or more.
(7)	State and local income tax refunds	$10.00 or more.
(8)	Interest payments	$10.00 or more.
(9)	Dividends and distributions	$10.00 or more.
(10)	Original issue discount	$10.00 or more.
(11)	Distributions from Individual Retirement Arrangements	$10.00 or more.
(12)	Patronage dividends	$600.00 or more.
(13)	Rent or royalty payments	$600.00 or more.
(14)	Prizes and awards	$600.00 or more.
(15)	Medical payments	$600.00 or more.
(16)	Nonemployee compensation	$600.00 or more.
(17)	Agricultural payments	$600.00 or more.
(18)	Taxable grants	$600.00 or more.
(19)	Discharge of Federal indebtedness	$600.00 or more.
(20)	Distributions from retirement and profit sharing plans	$600.00 or more (varies with type of wager).
(21)	Gambling winnings	$600.00 or more.
(22)	Mortgage interest statement	
(23)	Acquisition or abandonment of secured property.	
(24)	IRA contributions.	

1.4 percent of all partnership returns and only 2.4 percent of all corporate tax returns are presently audited by the Service. Nor does any other IRS Program begin to approach the Foreign Information Reports Program, in the breadth of its tax compliance coverage.

It is important to note that ours is increasingly a global economy. Beyond the 1.8 million Americans living and earning income abroad, there are additional millions of Americans here at home who invest overseas and earn billions of taxable dollars from those investments. U.S. individuals and businesses earned approximately $91 billion in legal sector foreign source income in 1984, $59 billion of which was essentially interest and dividend income.[7] If our Government's inability to assess and collect taxes from Americans abroad is due, in some substantial measure, to an inadequate foreign information returns program, then that system must be improved. If it is not improved, then the entire world beyond our borders will be a tax haven shielding foreign income earned by all Americans, wherever they live.

The Commerce, Consumer, and Monetary Affairs Subcommittee has had a longstanding oversight interest in and commitment to the efficient functioning of our tax laws. In the international tax administration area, this interest has expressed itself in numerous hearings over the years to examine issues such as the "Improper Use of Foreign Addresses To Evade U.S. Taxes" (February 28, 1984 and June 10, 1982); and "Tax Evasion Through the Netherlands Antilles and Other Tax Haven Countries" (April 13, 1983 and April 12, 1982). The subcommittee has also held hearings to study the IRS' Income Information Programs (April 29, 1986; October 1, 1980; March 9, 1978; and April 12, 1976). These and the subcommittee's other IRS hearings have been premised on the importance of tax fairness. If our self-assessment tax system is to survive, every taxpayer must believe that every other taxpayer—whether residing or investing inside or outside the United States—will fairly shoulder his or her share of the tax burden.

Although the tax loss to the Treasury resulting from the failure to collect all taxes due on foreign source income is difficult to quantify, the subcommittee believes that the loss is substantial and that the problem deserves swift and aggressive attention by the IRS and the Treasury Department.

Much of the data for this report resulted from an 11-month investigation conducted by the General Accounting Office (GAO) at the request of the Commerce, Consumer, and Monetary Affairs Subcommittee. In addition, the subcommittee conducted its own investigation, interviewed U.S. and foreign government tax authori-

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[7] "Survey of Current Business," Dec. 1985, Tables 1 and 2, U.S. Department of Commerce, Bureau of Economic Analysis. It is extremely difficult to pinpoint the precise amount of foreign source income or income earned abroad by U.S. taxpayers (individuals and business entities). Commerce's BEA placed the figure at $91 billion in 1985. IRS' Statistics of Income series reported that in 1982, U.S. corporations claiming foreign tax credits reported gross foreign source income of $87.5 billion (SOI Bulletin, vol. 5, number 4, spring 1986, pp. 9–30), individual Americans living abroad and claiming various exclusions from income based on foreign residency, reported $3.7 billion in foreign income (Compendium of Studies of International Income and Taxes 1979–1983, IRS, pp. 343–348). Under current IRS reporting requirements, it is not possible to determine how much foreign source income is "passive" income or other income that could theoretically be picked up on foreign information documents sent to IRS by foreign tax authorities.

ties and evaluated numerous documents bearing on the foreign source income issue, including an October 15, 1985, Booz-Allen and Hamilton report on IRS International Tax Enforcement Activities (commissioned by the Service), highly critical of its performance in this area.

II. Background

A. The General Accounting Office Investigation

As an adjunct to its own investigation, the Commerce, Consumer, and Monetary Affairs Subcommittee asked the General Accounting Office to attempt to quantify the overseas nonfiler and underreporter problem; and to evaluate the adequacy of the IRS response. In the course of its 11-month investigation, the GAO met with Government officials from Austria, Canada, France, West Germany, and the United Kingdom to determine if they maintain data on income earned or taxes paid by U.S. citizens residing within their countries. The GAO found that these countries maintain little information in a form that could be used to identify American nonfilers or underreporters. Nor did it find substantial information in the United States that would be available to IRS or GAO for the purpose of identifying overseas nonfilers.

In an effort to evaluate the magnitude of the nonfiler/underreporter problem and the potential tax revenue loss to the U.S. Treasury, the GAO was able to obtain tax-relevant information on Americans living abroad not generally available to IRS. The information identified the tax ID numbers of U.S. citizens residing in and around seven cities within four countries. Specifically, the General Accounting Office was able to obtain the tax ID numbers of 3,905 U.S. individuals residing in and around Hamburg, Germany; Vienna, Austria; Florence, Genoa, and Rome, Italy; and Tijuana and Nuevo Laredo, Mexico. The GAO then developed a computer program that identified possible nonfilers by matching the tax ID numbers of these 3,905 individuals against primary tax ID numbers on tax returns received by the Internal Revenue Service during the preceding 3 years.[8] Originally, the GAO planned to randomly sample the U.S. citizen resident population living in or around 46 cities in nine countries. These countries account for about 59 percent of the estimated total U.S. population residing abroad. The GAO found, however, that few of these locations maintain the type of information—names and tax ID numbers—it needed to make its match. Thus it had to limit its sample.

The tax ID numbers of U.S. citizens living abroad in the sample were matched by computer against the Internal Revenue Service's master list of individuals who had filed tax returns with the Service during the previous 3 years. If the tax ID number of a U.S. citizen living abroad did not show up on IRS' master list, then a tax return nonfiling problem was strongly indicated.[9]

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[8] GAO matched only the primary tax ID or Social Security numbers. This means that on joint tax returns which generally have two Social Security numbers, one for each spouse, only one of the numbers would have been detected through the computer match.

[9] Even if the individual had returned to the United States prior to the match taking place, the tax ID number of that individual should have shown up on IRS' master file.

While all U.S. citizens whose income exceeds the statutory minimum ($3,300 for individuals in 1984) must file an income tax return, the actual tax liability of such individuals residing abroad would be impacted by several tax benefits not generally available to taxpayers residing in the United States. These benefits include (1) excluding up to $80,000 of foreign *earned* income from U.S. taxable income and (2) deducting certain foreign housing expenses from U.S. taxable income. Additionally, U.S. citizens living abroad may elect to take a credit against their U.S. tax liability for any foreign taxes paid. In this regard, the Joint Committee on Taxation has estimated that the foreign earned income exclusion for U.S. citizens living overseas would result in reduced tax revenues of $2.6 billion during the period 1982–1986.

The GAO investigation was limited to the "individual" as taxpayer. It did not seek to determine whether American businesses based overseas were properly filing tax returns and reporting all income. Nor did the General Accounting Office determine whether the likely nonfilers identified had an actual tax liability. In order to do this, GAO would have had to furnish IRS with the identities of individuals in the sample so that IRS could contact them and determine their tax liability, if any. However, because the source of the identities of the Americans living abroad was somewhat sensitive, the subcommittee and GAO agreed that names in the sample would not be turned over to the Service.

B. ESTIMATE OF TAX LOSSES ATTRIBUTABLE TO NONFILING BY AMERICANS LIVING ABROAD

While it is not feasible to make a *definitive* estimate of tax loss to the U.S. Treasury resulting from the failure of large numbers of Americans living abroad to file tax returns, it is possible to make a rough calculation of that loss by using IRS' two most recent international income studies [10] and data from IRS assessments on delinquent accounts of overseas Americans. IRS' international data show that for TY 1979 (the latest published information available) 70 percent of tax returns with foreign earned income reported on IRS Form 2555 and filed by individual Americans living abroad, reflected a tax liability which averaged $6,640 per return.[11] Using (a) GAO's 61 percent nonfiling rate for the 1.8 million civilian Americans living abroad; (b) the same ratio of tax filing units to total population utilized by IRS in the United States (equivalent to 42 percent of the total population); and (c) the 70 percent of tax returns that had an average tax liability of $6,640 in 1979, it is possible to estimate that overseas nonfilers account for a total annual tax loss of $2.143 billion.[12] Unpublished and preliminary tax year

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[10] "Compendium of Studies of International Income and Taxes, 1979–1983," IRS Publication 1267 (9–85), pp. 343–8.

[11] The 63,249 tax returns out of 91,966 filed from abroad in TY 1979 reported taxable income of $2.495 billion, with taxes due of $420 million. The 28,717 returns filed on which no taxes were due, reported taxable income of $321.3 million which was offset by various exclusions and credits available to Americans living overseas.

[12] 1.8 million [civilian Americans] x 42% [percent of tax filing units (100 million individual returns) to total population in the United States (238 million Americans)] x 61% [nonfilers] x 70% [percent with a tax liability] x $6,640 [average dollar liability per return].

1983 international tax data indicate a somewhat lower, but still serious tax loss. They show that 44 percent of the 160,294 individual returns reporting foreign income on Form 2555, earned by Americans living abroad, had taxable income. The average per return tax liability for these 70,222 returns was $4,727. Assuming a nonfiling rate of 61 percent for the 1.8 million nonmilitary Americans living abroad and the same ratio of tax filing units to total population assumed above, the annual tax loss to the Treasury would be just under $1 billion ($959.16 million). A third measure of the total possible tax loss resulting from the nonfiling of tax returns by Americans living abroad derives from IRS' assessment experience on delinquent returns it secured from taxpayers living abroad. When IRS testified at the subcommittee's hearing in May 1985, it stated that in 1984, it secured a little over 18,000 delinquent tax returns from overseas U.S. taxpayers that had not been properly filed. In subsequent correspondence with the subcommittee, the Service reported that "the amounts assessed on these 18,000 delinquent returns totaled $34.6 million—an average of $1,922 per return.[13] Utilizing the same formula as above, but with an average tax liability of $1,922 per delinquent return, total tax liability for overseas nonfilers would be $620.4 million.

While these dollar figures vary and provide only rough estimates of annual tax losses,[14] they are nevertheless suggestive of a substantial tax loss problem that requires immediate IRS attention. This is particularly so when one considers that the $620 million to $2 billion tax loss calculation *excludes tax losses on unreported foreign source passive income earned by Americans living in the United States but investing abroad.*

III. Findings

(1) (a) Substantial evidence exists that large numbers of U.S. taxpayers living abroad fail to file Federal income tax returns or underreport their income when returns are filed. An investigation by the General Accounting Office and internal IRS documents strongly suggest that the nonfiling rate for the 1.8 million civilian Americans living outside the United States is as high as 61 percent—12 times greater than the 5-percent nonfiling rate for Americans living at home.

(b) The tax loss to the U.S. Treasury resulting from *overseas nonfilers* can be estimated at three-quarters of a billion dollars to as much as $2 billion annually.

(c) While it is not possible to calculate the *additional tax loss* on the *unreported* portion of the tens of billions of dollars in foreign source income earned annually by *American taxpayers resident in the United States,* the amount is likely to be very substantial.

(2) IRS' only method for *systematically* detecting overseas nonfilers and underreporters of foreign source income—the Foreign Information Reports Program (FIRP)—is dangerously deficient. The FIRP program, which is designed to provide IRS with independent

[13] Hearing, p. 65. See also, May 27, 1986, IRS letter to subcommittee Chairman Barnard, item 2.

[14] Because they include a number of assumptions difficult to prove.

information on income earned abroad by Americans, suffers from the following serious defects:

(a) *No* foreign information documents are received by IRS from *150 of the 167 countries in the world.* Among the 90 percent of the world's countries not furnishing information documents are: All the nations of Latin and Central America, including Mexico; major European and Far Eastern countries like Greece, Spain, Portugal, India, Hong Kong, Taiwan, Singapore and Indonesia; and most of Africa.

(b) Although the United States has income tax treaties or protocols with 37 countries providing for the exchange of tax information, including the furnishing of income information documents, *half of these countries regularly fail to provide IRS with such documents.* In 1985, for example, *no* "matchable" income information documents were received from tax treaty partners Italy, Greece, Belgium, Norway, Ireland, Japan, and Korea.

(c) The 17 tax treaty countries that do furnish IRS with income documents, provide an absurdly small number when measured against the large number of Americans living or investing in those countries. In 1985, all of our tax treaty partners combined—excepting Canada—furnished the Service with only 15,199 matchable foreign information documents: Australia furnished 326; Austria, 1; Denmark, 3; Germany, 252; South Africa, 5; Sweden, 221; France, 1,109; and the United Kingdom, 4,602. Canada furnished 357,505.

(d) Out of the $91 billion in foreign source income earned by Americans in 1984, only $536 million (one-half of 1 percent) was reported to IRS by foreign tax authorities on matchable income documents.

In this regard, a September 30, 1985, IRS internal audit report found that the Service received no foreign information documents from 25 of the 40 largest banks thought to be widely used by Americans in four countries with whom we have exchange of information agreements.

(e) Of the extremely small number of foreign income information documents for individuals that are received by IRS, only about 60 percent, on the average, enter the computerized program to be matched against tax returns. In 1985, the number of processable foreign information documents actually declined to 53 percent.

(f) (i) The already inadequate number of FIRP documents being received by the IRS will soon be reduced by 50 percent as a result of the Service's decision, in early 1984, to encourage our tax treaty partners to join in the establishment of a "dollar tolerance level," below which income information documents would not be exchanged. Ten of our tax treaty partners [15] have agreed not to send income documents below this tolerance level.

(ii) Because all income information documents—no matter how small the income reported—provide IRS with valuable leads on nonfilers as well as underreporters, the establishment of a toler-

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[15] Sixteen treaty partners replied to IRS' letters, 10 of whom currently provide information, and informed the Service that they would also implement a tolerance factor. They are: Canada, Denmark, Finland, France, Ireland, Japan, New Zealand, Switzerland, Trinidad, and United Kingdom. These countries agreed to implement a tolerance factor with respect to tax year 1984 documents, which the United States receives in 1985. The United States implemented its tolerance factors with respect to documents sent to treaty partners after September 30, 1984.

ance factor is likely to diminish the Service's ability to detect tax evaders.

(g) The total number of foreign information documents sent to IRS has not increased in a meaningful way over the past 5 years even though foreign source income earned by Americans during this period has increased dramatically. In 1980, IRS received 673,237 documents. In 1985, it received 714,779. During this same period, the number of matchable documents has actually declined from about 60 percent to 53 percent.

(3) (a) Because the Foreign Information Reports Program is so severely deficient, there is little likelihood that IRS can systematically identify:

Americans living abroad who either fail to file tax returns or underreport their foreign source income, and

American individuals and businesses resident in the United States who earn billions of dollars from direct and portfolio investments abroad ($91 billion in 1984)—a matter of even greater concern from a tax loss point of view.

(b) In connection with the above, it is instructive to consider that in 1984:

U.S. taxpayers earned $25.3 billion in dividend and interest income and $867 million in direct investment income from Latin America—yet IRS receives no foreign income documents from Latin American nations to match against the tax returns of Americans investing there;

U.S. citizens earned $3.6 billion in interest and dividend type income and $761 million in direct investment income from Japan—yet IRS received no foreign information documents from Japan in 1985 (reporting 1984 income); and

U.S. taxpayers earned $15.7 billion in dividend, interest and related portfolio income and $8.9 billion in direct investment income from Western Europe—yet IRS received in calendar 1985 (covering tax year 1984), only 12,646 foreign income documents for individuals and a much smaller number for U.S. business firms.

(4) The negative consequences of an ineffectual foreign information reports program are severe: *First,* billions of dollars in taxes due the U.S. Treasury are conceivably lost. (IRS estimates that in 1986, its *domestic* Information Returns Program covering U.S. source income will produce $3 billion in taxes that would not have been collected without the matching.) *Second,* because "mismatches" found through the Information Returns Program provide IRS with important "leads" concerning tax evasion activities, an inadequate FIRP will produce far fewer audits and examinations of taxpayers who may be engaged in such activities.

(5) Although most foreign source income is earned by U.S. corporations and other business entities, IRS has no computerized document matching program for business income. Accordingly, the Service does not presently know whether U.S. businesses operating and investing abroad are fully reporting their foreign source income for tax purposes.

(6) (a) Because IRS has never fully implemented the recommendations of its internal auditors to measure the extent of tax evasion on foreign source income paid to U.S. citizens, it cannot quantify

the tax losses resulting from the failure of Americans living and/or investing abroad to file returns or fully report their foreign source income. Nevertheless, given the large dollar value of foreign source income earned by U.S. taxpayers and the ineffectiveness of IRS' practices and procedures for detecting nonfilers and underreporters, the losses to the Treasury are likely to be immense.

(7) The IRS' Foreign Information *Documents* Program—which involves the processing of large dollar foreign information reports that cannot be used in the automated matching program—requires major improvement. In 1984, 4,000 foreign information documents reporting $1.6 billion of income to Americans were improperly excluded from the program because of Philadelphia Service Center errors and inadequate national office guidelines.

(8) The Internal Revenue Service and the Treasury Department must assume a measure of responsibility for the ease with which Americans living or investing abroad can overlook or even evade their tax responsibilities:

(a) Although foreign tax laws and the cooperation of foreign tax authorities strongly influence the ultimate success of our Nation's efforts to identify unreported foreign source income, Treasury has been insufficiently aggressive in pursuing with our tax treaty partners and others, the imperative of better exchanges of tax information. In this regard, Treasury attachés serve at only 10 U.S. diplomatic posts around the world (Bern, Bonn, Brasilia, London, Mexico City, Ottawa, Paris, Riyadh, Rome, and Tokyo) even though they are the U.S. Government's principal liaisons abroad with foreign tax authorities. By way of contrast, the United States has agricultural attachés at 70 embassies or consulates; labor officers at 47 diplomatic posts; mineral officers at 10 posts; and science attachés at 27 posts.

(b) Because IRS has initiated a dollar tolerance level for FIRP documents, the number of income reports it receives from foreign tax authorities will be reduced by half; and its ability to identify nonfilers and underreporters, diminished.

(c) The IRS has often failed to carry out its tax assessment and collection responsibilities against overseas nonfilers it *has* identified, by choosing to close rather than pursue cases.

(d) The IRS has responded inadequately to the recommendation of its internal auditors that the Service "accurately estimate * * * the full scope and growth of international activities by U.S. taxpayers * * * and the potential revenue loss."

(e) There has been a 50-percent reduction over the past 5 years in the number of examinations of tax returns filed by Americans living abroad. In FY 1981, 15,475 tax returns were audited by the Foreign Operations District, with additional taxes and penalties totaling $47,465,408. In FY 1985, 8,048 returns were audited with *proposed* assessments totaling $69,764,279. Although IRS appears to be auditing returns with larger tax revenue consequences, reductions of this magnitude in the numbers of returns examined are likely to diminish overall tax compliance.

(f) While the Service has taken some useful steps to identify and provide tax information to Americans leaving the United States on a permanent or semipermanent basis, its efforts need to be accelerated.

(g) Current IRS taxpayer forms and schedules fail to properly highlight foreign source *investment* income earned by individual and business taxpayers resident in the United States who do not claim a foreign tax credit. This lack of specificity could discourage taxpayers from fully reporting foreign source passive income and impede IRS' ability to identify gaps in the Foreign Information Reporting Programs of specific countries.

IV. Recommendations

A. The Foreign Information Returns Program: Meeting the Need for Better Exchanges of Tax Information

1. Tax losses on foreign source income will continue at unacceptable levels absent substantial improvement in the quantity and quality of foreign information documents sent to IRS. In order to increase the flow and accuracy of these documents the committee recommends the following:

(a) The executive branch of Government should mount a major campaign to convince our tax treaty partners and officials of other nations of the importance of comprehensive exchanges of tax information. The success of this campaign will be enhanced if (i) the State Department would join with the Treasury Department in making this issue a matter of high-level foreign, as well as, tax policy, and (ii) the Treasury Department would increase the number of Treasury Financial Attachés at our embassies around the world and emphasize their role in improving government-to-government cooperation on tax compliance issues.

(b) In order to increase the numbers of countries furnishing IRS with foreign income information documents, the Treasury Department's International Tax Counsel should immediately begin efforts to negotiate exchange-of-tax-information agreements with nations with whom we do not have (and are not soon likely to have) full blown tax treaties. Many nations should be amenable to such limited agreements so that they could begin receiving from IRS information documents on U.S. source income earned by their taxpayers.

(c) The quantity and quality of foreign income documents presently sent to IRS are necessarily limited by the tax laws of foreign countries [16] and by the competency of those countries' tax authorities.[17] Accordingly, Treasury and the Service should begin face-to-face discussions with foreign business firms employing large numbers of Americans overseas and with major foreign payors of interest, dividend and other investment income to Americans, seeking their agreement to voluntarily report such wage and investment income to IRS, either directly or through their foreign tax authority. This program should only supplement and not supplant the existing FIRP/exchange of information effort.

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[16] Because certain types of income earned abroad are not taxable to citizens and/or noncitizens of a particular country or are otherwise not reportable to the tax authority of that country, no income reports can be sent to the Service.

[17] Because documents sent to IRS often arrive too late or fail to contain a tax ID number or complete information.

(d) IRS should rescind the agreements it entered into with 10 of our tax treaty partners establishing a dollar tolerance level for exchanges of tax information documents. These agreements diminish IRS' ability to identify nonfilers living abroad and underreporters of foreign source income.

2. So that IRS can better understand the nature and extent of tax evasion and losses on foreign income and the methods it should employ to assure the assessment of all taxes due on such income, the Service should begin immediately a Tax Compliance Measurement Program (TCMP) study devoted to the issue of foreign source income.

B. TAX RETURN NONFILING AND UNDERREPORTING BY AMERICANS LIVING ABROAD

In order to encourage the filing of tax returns and proper reporting of tax by Americans living abroad, the committee recommends the following:

(1) The number of IRS Revenue Service Representatives stationed abroad should be increased from its present level of 32 to at least double this number.

(2) The number of tax returns from Americans abroad audited by the IRS' Foreign Operations District should be increased substantially, at least to 1981 levels.

(3) Because there is widespread misunderstanding by Americans living abroad of their tax responsibilities, IRS should never close cases on Americans overseas who indicate a misunderstanding of those tax responsibilities.

(4) Approximately 250,000 U.S. citizens living abroad file passport renewal applications each year through our embassies and consular posts. In an effort to identify possible nonfilers and, consistent with the Privacy Act, IRS should request from the State Department the names and Social Security numbers of adult Americans who have applied for passport renewals within the recent past and match those names against its master file of taxpayers. "Perfection" by IRS of such a passport list could greatly assist in the identification of overseas nonfilers.

C. IMPROVED COMPLIANCE THROUGH BETTER UTILIZATION OF TAXPAYER FORMS AND SCHEDULES

In order to increase the likelihood of full reporting, by taxpayers, of their foreign source investment income, IRS should consider improvements or additions to its income tax reporting forms and schedules. While worldwide investment income is currently reportable on the 1040 and various 1120 forms, tax compliance could be improved through a highlighting of foreign source income on existing forms likely to be utilized by Americans resident in the United States but investing abroad, and by Americans living abroad who do not claim exclusions from income based on foreign residency. In this regard, consideration should be given to:

(a) Creating space on the 1040 form where earned and investment foreign source income would each be reported separately from U.S. source income. Although schedule B contains a question on the existence of foreign accounts with a value above $5,000,

space on the 1040 itself requiring separate reporting of all foreign source earned and investment income could be a strong inducement to U.S. taxpayers to fully report such income. Consideration should also be given to how corporation tax forms and schedules could also be improved to highlight foreign source earned and passive income; and

(b) Revising Form 2555 (Foreign Earned Income)—now used by U.S. taxpayers living abroad who claim exclusions and deductions based on foreign residency—to include a separate section on foreign source *investment* income. Presently, only wage or other "earned" income is reported on this form.

V. Discussion

A. A LARGE NUMBER OF U.S. CITIZENS LIVING ABROAD ARE NOT FILING TAX RETURNS

1. The GAO study

In an effort to estimate the extent of the overseas nonfiler problem, the General Accounting Office matched the tax ID (Social Security) numbers of 3,905 U.S. citizens living in Germany, Austria, Italy and Mexico against primary tax ID numbers on tax returns in IRS' Master File.[18] As a result of this match, the GAO found no record of tax returns being filed over 3 tax years, 1981–1983 by 2,376 or 60.9 percent of the individuals in its sample. The table set forth below, provides a city-by-city and gender-by-gender breakout of the GAO survey. It shows that the likely nonfiling rate ranges from a low of 37 percent in the two Mexican cities sampled to a high of 66.7 percent in the three Italian cities studied.

The computer program used to identify possible nonfilers matched the Social Security numbers of the individuals in the sample against primary Social Security numbers shown on tax returns. This means that on joint returns, which generally contain two numbers, only one of the numbers whould have been detected through the computer match. Thus, the results may include a certain number of apparent nonfilers who may, in fact, have filed a joint tax return. On the other hand, when the match was limited only to the males in the sample, the results still indicated a serious potential nonfiling problem. Of the 1,825 males in the GAO sample, 907 or 50 percent did not file a tax return for years 1981–1983. Moreover, even if GAO's finding of a 61-percent probable nonfiling rate was inaccurate by half, it would still indicate an overseas nonfiler rate of six times the domestic average of 5 percent.

[18] GAO's sample did not include the 950,000 U.S. military personnel and families stationed abroad.

RESULTS OF MATCH BY CITY FOR FEDERAL INCOME TAX RETURNS FILED BETWEEN TY 1981 AND TY 1983

City	Totals					Male					Female				
	Total	Record of return	Percent	No record of return	Percent	Total	Record of return	Percent	No record of return	Percent	Total	Record of return	Percent	No record of return	Percent
Hamburg	1,197	370	30.9	827	69.1	535	216	40.4	319	59.6	662	154	23.3	508	76.7
Vienna	502	301	60.0	201	40.0	276	199	72.1	77	27.9	226	102	45.1	124	54.9
Florence	497	210	42.3	287	57.7	206	108	52.4	98	47.6	291	102	35.1	189	64.9
Genoa	846	189	22.3	657	77.7	347	95	27.4	252	72.6	499	94	18.8	405	81.2
Rome	306	108	35.3	198	64.7	146	57	39.0	89	61.0	160	51	31.9	109	68.1
Nuevo Laredo	108	68	63.0	40	37.0	46	35	76.1	11	23.9	62	33	53.2	29	46.8
Tijuana	449	283	63.0	166	37.0	269	208	77.3	61	22.7	180	75	41.7	105	58.3
Total	3,905	1,529	39.1	2,376	60.9	1,825	918	50.3	907	49.7	2,080	611	29.4	1,469	70.6

The GAO did not determine whether the possible nonfilers it identified had an actual tax liability. In order to do this, GAO would have had to furnish to the Service the identities of those individuals whose tax ID numbers it had secured. However, because the source of these tax ID numbers was somewhat sensitive, the GAO, by arrangement with the subcommittee, did not disclose this information to the Service. On the issue of actual tax liability, U.S. citizens living abroad are affected by several tax benefits not generally available to domestic taxpayers including a foreign earned income exclusion of up to $80,000 and a credit for taxes paid to foreign governments.

However, whether or not a tax is owed, virtually all individual Americans living abroad with minimal income (above $3,300 in 1984) *are* required to file tax returns. There is some evidence that Americans living abroad, both those in the active work force and those in retirement, enjoy an income substantially above that requisite for the filing of a tax return. Testimony submitted to the subcommittee by the Asia-Pacific Council of American Chambers of Commerce stated that "the average estimated earned income of a U.S. expatriate in Japan is $135,000; in Indonesia is $130,000; and in Singapore is $125,000." [19] It is likely that for individuals with this earning capacity, unearned or investment income would add substantially to their overall net worth.

Data on Social Security recipients and changes in the law governing the taxation of Social Security income also suggest that many Americans living abroad in retirement status should be filing tax returns. Benefits received by U.S. citizens after 1983 may be taxable, depending on the total amount of income and the filing status of the taxpayer. For a U.S. citizen living abroad, the amount to include in gross income "is whichever of the following is less: (a) half the Social Security benefits received during the tax year, or (b) half the excess of the sum of (1) modified adjusted gross income plus (2) half the Social Security benefits, over the applicable base amount." [20]

2. IRS' acknowledgment of the overseas nonfiler problem

The Internal Revenue Service is itself satisfied that a substantial overseas nonfiling problem exists. IRS' concern is predicated, in part, on the disparity between the numbers of Americans living abroad and the numbers of tax returns filed from abroad each year: Although the State Department estimates that about 1.8 million U.S. citizens lived abroad in 1983, only 246,000 individual income tax returns were filed with IRS that year—a filing rate of 13.7 percent. This contrasts with a projected filing rate of 42 percent for taxpayers residing in the United States in FY 1985 (based on a population of 239 million Americans and 100.8 million primary tax returns from individuals received by IRS).

Additionally, IRS identified for tax year 1982, through its Nonfiler Program, approximately 15,100 cases of suspected nonfiling by U.S. taxpayers living abroad. In 1984, IRS secured about 18,000 de-

[19] Ibid., p. 106.
[20] Tax Guide for U.S. Citizens and Resident Aliens Abroad, for Use in Preparing 1985 Returns, Publication 54, Department of the Treasury, p. 28.

linquent returns involving overseas taxpayers and assessed taxes on the 18,000 returns totaling $34.6 million.[21] Overseas nonfiling was described by IRS at the subcommittee's hearing as a practice "* * * on the increase." The Service witness at the subcommittee's hearing also stated that the IRS "continues to be concerned about the noncompliance with U.S. tax laws both domestically and internationally:"

> Mr. BARNARD. Mr. Owens, do you and your associates at IRS really believe we have a nonfiling problem with American citizens living abroad?
>
> Mr. OWENS. Mr. Chairman, I think we have a problem not only with taxpayers living abroad but also here in the United States. We have made this study. So we have a problem both here and a problem abroad.
>
> Mr. BARNARD. But the significance of the problem, probably not so much in numbers, but certainly in percentage, is much higher from citizens living abroad.
>
> Mr. OWENS. Based on what I heard from the GAO testimony, I would agree with that, Mr. Chairman.
>
> Mr. BARNARD. But the question is, do you think that the problem of [Americans] living abroad is sufficiently important that it requires some further attention of the IRS?
>
> Mr. OWENS. Yes, Mr. Chairman, I think it does. I think the difficulty we have, though, is determining what actions we can take that will make these programs more effective. That is the difficulty we have in addressing it. The difficult question is then, what attention and how can we go about doing that and how can we get more information in order to be more effective. I think as a person moves out of the country, the likelihood of them complying with the laws in this country, whether it be tax laws or any other laws that may be applicable to them, is less.[22]

B. IRS IS NOT DEALING ADEQUATELY WITH THE OVERSEAS NONFILING PROBLEM

1. The GAO evaluation

In addition to estimating the numbers of overseas nonfilers, GAO evaluated the adequacy of IRS' efforts to collect taxes on foreign source income. The General Accounting Office testified that notwithstanding IRS' belief that many U.S. citizens living abroad are not filing Federal income tax returns or are underreporting their income, it has not adequately dealt with the problem. Its conclusion was predicated on several findings:

First, that while there is little foreign or U.S. information *presently* available to the Service that would help it identify overseas nonfilers and underreporters, IRS has not pressed for better data. Based on its discussions with foreign government officials in Austria Canada, France, West Germany and the United Kingdom, GAO determined that while there are various sources of income in-

[21] Hearing pp. 28 and 65. See also May 27, 1986, IRS letter to subcommittee Chairman Barnard.

[22] Ibid., pp. 57 and 91.

formation abroad, this information generally does not contain references to an individual's citizenship. Without such a reference, the foreign tax authority has no basis for sending an income information report to the Internal Revenue Service. GAO also learned that there is very little natural incentive for a foreign tax authority to seek citizenship information. France, for example, is essentially concerned that if a person resides in France, their income may be subject to French tax.[23] It has little interest in enforcing the Internal Revenue Code which requires the taxation of worldwide income of U.S. taxpayers. Moreover, in the view of some, such an effort could discourage U.S. investment overseas.

Second, that little information is presently maintained in the United States in a form that would help IRS identify which Americans are residing overseas or earning income from foreign sources; and that IRS abandoned a program to accomplish this purpose without measuring its usefulness. In the mid-1970's IRS attempted to identify potential overseas nonfilers with the cooperation of the State Department. The effort involved State Department Foreign Service Post officials requesting U.S. citizens living abroad to complete IRS Form 3966 (IRS identification of U.S. citizens residing abroad) when they applied for passport and registration services. The form provided useful information to both U.S. citizens and the Service. For U.S. citizens, the form cited the Federal tax responsibilities of Americans living abroad and provided them with information regarding the availability overseas of tax information and taxpayer assistance. The form benefited IRS by providing information on a U.S. citizen's occupation and when and where he or she last filed a Federal income tax return. IRS initially estimated that about 60,000 Forms 3966 would be filed annually. However, expected implementation never occurred primarily because there was no legal requirement that the form be filed. This meant that refusing to complete the form did not preclude a person from receiving passport and registration services from the State Department. IRS and State Department officials advised GAO that U.S. citizens complained that the form violated their privacy rights. For this reason and because the form was voluntary, IRS abandoned it in 1979 even though it did not measure its ultimate effectiveness.[24] IRS advised the subcommittee that the form was abandoned "because there was no statutory authority to require its completion or filing by U.S. citizens."[25] IRS never sought statutory authority to require Americans traveling abroad to complete Form 3966 or an equivalent form.

Third, that IRS' Nonfilers Program and its Stopfilers Program (designed respectively, to detect those taxpayers who should, but do not, file tax returns or those who filed tax returns for the previous tax year but not for the current tax year) are only of minimal value. Basically, in order for the Nonfiler Program to operate, IRS must receive a taxpayer wage or salary statement (Form W-2) or an income information report (Form 1099), but not a tax return. When the Service attempts to match a taxpayer's income informa-

[23] Ibid., pp. 18 and 19.
[24] Ibid., pp. 22 and 23.
[25] Ibid., p. 206.

tion document with a tax return, it finds that no tax return has been filed. The Stopfiler Program attempts to match tax ID numbers from the previous year's tax return with that from the current year's return. If a current return is not on file, then IRS is alerted to the possibility of a nonfiler situation.

Unfortunately, the success of the Nonfiler Program, as it pertains to Americans living abroad, is seriously impeded by the extremely small number of foreign income information documents or their lack of completeness. For example, in 1985, only 24 percent of these FIRP documents had taxpayer ID numbers, without which computerized document matching cannot take place.

The limitation on the Stopfiler Program is that it depends on the existence of a prior year's tax return. If tax returns have not been filed for several years, the Stopfiler Program may not detect the absence of a return for the current tax year.

Fourth, that even when a possible overseas nonfiler *is* identified, the Service frequently fails to pursue its tax assessment and collection responsibilities even though it knows who and where these people are. In this regard, GAO randomly selected 353 out of 15,100 cases of possible overseas nonfiling identified by IRS in tax year 1982, including cases in which the taxpayers responded to an IRS notice of possible nonfiling. In 113 instances, the taxpayers cited reasons for their failure to file tax returns that were totally erroneous, such as that their foreign residency exempted them from U.S. taxation. GAO found, however, that in all 113 cases, "IRS made no attempt to communicate to these taxpayers the filing requirement of U.S. citizens living overseas." Instead IRS closed the cases: [26]

> Mr. BARNARD. Mr. Finch, you testified that in 32 percent of the cases in your sample where IRS had identified nonfilers residing abroad, IRS simply accepted the taxpayer's statement as to why they did not file a return.
>
> How many of these statements were erroneous?
>
> Mr. FINCH. I think they were all erroneous as reasons for not filing a return.
>
> Mr. BARNARD. What specifically did the IRS do when they received the taxpayers' statements?
>
> Mr. FINCH. For the cases in our sample, they closed the cases.
>
> Mr. BARNARD. Are you saying that IRS simply closed the cases without at least alerting the taxpayer that the reason for not filing the statement was incorrect?
>
> Mr. FINCH. That is correct, sir. For the cases in our sample, that is what happened.[27]

Fifth, notwithstanding the vital importance of the Foreign Income Information Reports Program (FIRP) to IRS' tax administration responsibilities for Americans living and/or investing abroad, GAO found that the Service receives no income information documents from countries with whom we have no tax treaties; and, excepting Canada, very few income information documents from our tax treaty partners, such as Italy, Denmark, Austria, the

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[26] Ibid., pp. 28–37.
[27] Ibid., p. 37.

Netherlands, West Germany, and France. Without these documents, the IRS has virtually no systematic way of determining whether taxpayers receiving foreign source income are filing tax returns or reporting all of their income.

Sixth, IRS' efforts at communicating with Americans living abroad in a permanent or semi-permanent basis, lacked effectiveness. The GAO found, for example, that:

> The notices that IRS sends to possible overseas nonfilers that it identifies make no mention of the special provisions that apply to U.S. citizens living abroad. The computerized form sent to possible overseas nonfilers is identical to the form sent to possible nonfilers residing in the U.S. . . . We think that when IRS sends its first notice to taxpayers abroad, it should assume that the taxpayers are unaware of their filing requirements. Therefore, the notice should contain information explaining these requirements. . . .
>
> IRS personnel with whom we have discussed this matter agree that providing such information would be useful. The information could either be outlined in a flier included with the notice or made part of the notice itself at very little cost to IRS. For example, IRS could add one or two paragraphs to the current notice or print a short one page flier to accompany the notice. Regardless, the information would serve to explain the filing and tax requirements for U.S. citizens living abroad.
>
> We believe that providing accurate information to U.S. citizens living overseas regarding their filing and tax requirements could have a positive effect on compliance. Not only would it help individual taxpayers understand and comply with the requirements, it could also improve compliance by reducing the chance of misinformation being spread among U.S. citizens living overseas. In this regard, U.S. government and private sector officials told us that U.S. citizen communities overseas are generally tightly knit and that interpersonal communication networks are very active. Thus, inaccurate information concerning tax filing requirements could spread far beyond those U.S. citizens receiving notices from IRS. Any action which serves to reduce the spread of inaccurate or erroneous information could serve to reduce the possibility of additional noncompliance.[28]

The subcommittee is also concerned over the declining number of examinations by the Foreign Operation District of tax returns filed by Americans abroad. In fiscal year 1981, the Foreign Operation District conducted 14,419 examinations of returns by auditors and 1,056 by Revenue Agents. Those numbers have declined each year subsequently. By FY 1985, only 7,494 examinations by auditors were conducted and only 554 by Revenue Agents—a reduction of about 50 percent.

The IRS does publish a number of guides for U.S. citizens living abroad. The most relevant are Publication 54, "Tax Guide to U.S.

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[28] Ibid., pp. 30–31.

Citizens and Resident Aliens Abroad"; and Publication 593, "Income Tax Benefits for U.S. Citizens Who Go Overseas." These publications are available in the United States and abroad at 15 IRS foreign offices and at U.S. Embassies or consulates—but they have to be requested by the taxpayers. There is no "affirmative action" program to get these guides into the hands of Americans going abroad or already living abroad.[29]

In connection with tax forms it sends to U.S. taxpayers overseas, in 1984, IRS began to send a 2-page "fact stuffer" highlighting foreign tax issues. For tax year 1985, IRS mailed abroad 363,787 tax forms for individuals and 25,379 business returns.[30]

IRS also testified that its public affairs officials work with the international media and the U.S. Information Agency to provide information to Americans in foreign countries; and that its taxpayer service specialists travel to various U.S. Embassies to offer assistance.[31]

2. IRS lacks data on the nature and extent of the overseas nonfiler and underreporter problem

During its many years of oversight of the Internal Revenue Service, the subcommittee has been generally impressed with the Service's efforts to establish the costs and benefits of its assessment, collection and audit programs. Traditionally, each dollar expended by the Service returns from $6 to $30 to the U.S. Treasury, depending on the specific function measured. Although the IRS has never stated directly that problems relating to the collection of taxes on foreign income occupy a low priority, the evidence suggests that this is the case. Quite simply, IRS does not have persuasive data on the costs of the overseas nonfiler and underreporter problem:

> Mr. OWENS (Acting IRS Commissioner). We simply do not have any information on the numbers of people that do not file returns overseas, or those who do not report all of their tax liabilities, simply because of the lack of availability of information.
>
> Mr. BARNARD. I certainly don't have any figures, but I asked Mr. Finch [of the GAO] a while ago whether or not the revenue produced and the relative cost, whether it would be cost beneficial.
>
> I mean do you look into those things from time to time?
>
> Mr. OWENS. Yes, we do consider those. We consider those both for international taxpayers as well as domestic taxpayers in designing our programs in terms of cost.
>
> We would certainly direct our resources hopefully first at those with the highest noncompliances in terms of dollars, rather than in the lower areas.[32]

The subcommittee concurs in the importance of cost/benefit analysis in establishing budgetary priorities. In the case of the overseas nonfiler and the foreign income underreporter problem, however,

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[29] Ibid., p. 43.
[30] March 13, 1986, IRS communication to Doug Barnard, Jr., Chairman, Commerce, Consumer, and Monetary Affairs Subcommittee.
[31] Hearing, pp. 43–44.
[32] Ibid., p. 57.

the IRS lacks the data to make a determination of the tax loss to the Treasury; and notwithstanding the recommendations of its own internal auditors, has demonstrated little interest in obtaining the data. In a September 5, 1984, internal audit report (04224) entitled "The Service's Use of Information Reports and Documents on International Transactions," IRS auditors concluded that:

> To further improve the overall international compliance program, the Service should study ways to determine the full scope, growth and level of compliance in the international area and to develop more effective uses of the information it receives. Although the Service has received relatively few information documents which report international transactions, no attempts have been made to determine what level of compliance the filings represent. As a result, the full scope and growth of international activities by U.S. taxpayers are unknown and the potential revenue loss cannot be accurately estimated.[33]

C. SERIOUS PROBLEMS EXIST IN THE FOREIGN INCOME INFORMATION REPORTS PROGRAM

IRS has never made any secret of the fact that its Information Returns Program—both domestic and foreign—is central to its ability to identify, in any systematic fashion for the universe of taxpayers, those who fail to file their income tax returns or who underreport their income when they do file. The Service, in cooperation with the Congress, has made meaningful progress over the years in increasing the types of income producing transactions that must be reported to the IRS. In the recent past, capital gains and losses on the sale of securities, futures, commodities and bartering transactions, State and local income tax refunds, and rent or royalty payments have been added to the list of income payments and deductions that payors must report to the IRS. The Service has also improved its performance in matching *domestic* income information documents against information contained in tax returns filed with the IRS. Clearly, IRS' ability to process reports of income earned by taxpayers across a broad range of economic activities and to match these reports against information contained in tax returns, constitute the single most important device available to the Service to detect widespread nonfiling and underreporting.

Unfortunately, the substantial progress made in receiving and utilizing *domestic* income information returns has not been matched in the area of foreign source income earned by Americans either living abroad or here at home. IRS maintains that it has made meaningful progress in securing additional and more complete income information returns from our foreign tax treaty partners; and that, in fact, it goes to much greater lengths than ever before to perfect foreign information documents that lack necessary information and then utilize those documents in its assessment and collection activities. As an example, it cites the fact that in 1984 the Service secured over 18,000 delinquent returns through Foreign Operations District Office, from taxpayers living abroad,

[33] Internal Audit Report, September 5, 1984.

primarily as a result of the Information Return Program.[34] IRS also cites specific progress in the utilization of foreign information returns. A September 5, 1984, IRS internal audit report entitled "The Service's Use of Information Reports and Documents on International Transactions" (Reference No. 04224), found extensive problems with the foreign information reports program:

> The amount of foreign investments by U.S. taxpayers and foreign income received by U.S. taxpayers has increased dramatically during the past few years. These foreign transactions may result in sizeable U.S. tax liabilities depending upon the form and circumstance of the income and investments.
>
> The focal point for the Service's effort to obtain voluntary compliance regarding international transactions is the International Enforcement Program (IEP) in the Office of the Assistant Commissioner (Examination).
>
> Two other compliance programs concerning foreign activities by U.S. taxpayers are the Foreign Information Returns Program (FIRP) and the Foreign Corporation Program.
>
> We recognize that the Service's problems in effectively using information are partly due to the various forms involved and the numerous sources that report information. However, based on our review, we believe there could be a more effective compliance program to identify nonfilers of foreign information returns and documents; improved procedures for using information received from treaty partners to determine whether taxpayers are accurately reporting their foreign source income; and a better system for utilizing information returns and documents to identify tax returns with audit potential for examination.
>
> An ineffective matching program may result in undetected foreign source income. Also, information which can be used to measure compliance and identify pockets of noncompliance has not been accumulated.
>
> The Service has taken action to improve the quality of the information documents received by encouraging treaty partners to utilize a standard information document for reporting the payments. Their cooperation would greatly enhance the Service's ability to economically process more documents. However, a substantial portion of the payments are to agents or nominees of the taxpayers. The documents for those payments, therefore, do not identify the taxpayers who ultimately receive the payments. In addition, no information documents are received from nontreaty countries.[35]

The IRS did respond in a positive fashion to the criticisms contained in the internal audit report. For example, it did add questions relating to international transactions to individual TCMP evaluation documents to provide some measurement of compliance

[34] Ibid., p. 65.
[35] Internal Audit Report, September 5, 1984.

levels. It also agreed to institute procedures to ensure that examiners at the time of examination of a return will be aware of, or have available, all international income information documents. Finally, IRS agreed to include all foreign income information documents in a single data base to be maintained in the Philadelphia Service Center.

Notwithstanding these apparent improvements, the number of usable foreign income information documents has not increased: Many tax treaty countries and all nontax treaty countries do not send IRS income information reports; and approximately one-third of the information documents which IRS does receive from foreign countries cannot be used in the matching program either because they lack essential information or because they are received too late to be used as part of a current year's audit program. While the number of foreign information documents sent to IRS increased by 6 percent between 1980 and 1985 (from 673,237 to 714,779), the number of documents that could be used in the matching program has remained steady at about 66 percent. In fact, the number of processable documents actually declined in 1985 to 53 percent of all documents received.[36]

The essential failure of the foreign income information reporting program is that far too few documents are received by IRS to offer assurance that all foreign source income is being properly reported on tax returns. No income information documents are received from nontax treaty countries; many tax treaty countries either send no documents or a de minimis number; and, many of the documents sent are not usable. In 1984, for example:

U.S. taxpayers earned $25.3 billion in dividend and interest income and $867 million in direct investment income from Latin America—yet IRS receives no foreign income documents from Latin American nations to match against the tax returns of Americans investing there;

U.S. citizens earned $3.6 billion in interest and dividend type income and $761 million in direct investment income from Japan—yet IRS received no foreign information documents from Japan in 1985 (reporting 1984 income); and

U.S. taxpayers earned $15.7 billion in dividend, interest and related portfolio income and $8.9 billion in direct investment income from Western Europe—yet IRS received in calendar 1985 (covering tax year 1984), only 12,646 foreign income documents for individuals and a much smaller number for U.S. business firms.[37]

In tax year 1982, 680,510 foreign information documents pertaining to income earned by individuals were received by the IRS. Ninety-five percent of these documents (647,224) were received from one country, Canada. Notwithstanding the fact that there were approximately 35,000 Americans living in France in 1982 and thousands more resident Americans who invested there, France sent IRS only 3,266 income information documents representing earned income of $605,478. For tax year 1982, only 506 of those 3,266 documents (15.5 percent) were processed. Also for tax year 1982, the IRS received 137 individual foreign information returns

[36] Letter to subcommittee Chairman Barnard from IRS, May 15, 1986.
[37] "Survey of Current Business," December 1985, Hearing, p. 200.

from Australia representing payments of $1,249 notwithstanding the State Department's estimate that approximately 59,000 Americans lived there at that time. Denmark provides a further example of the disparity between the number of income information documents received and the size of the American population living or investing in that country. IRS received only 17 information returns from Denmark reporting income of $65 for tax year 1982, even though the U.S. population there was estimated to be 10,600 at the time.

Weaknesses in the foreign income information reporting system undermines tax assessment and collection effort for Americans not only living abroad but also living here and investing abroad.

The perils inherent in our current FIRP program are further illustrated by the absence of a tax treaty and the non-existence of income information reports from many major countries in the world where Americans live and invest. Mexico is perhaps the best example. The State Department estimates that there are well over one-quarter of a million Americans who live in Mexico on a permanent or semi-permanant basis. Indeed, more than 61,000 persons receive Social Security benefits there. While no figures exist on the total amount of earned and investment income received by these Americans or by Americans living at home and investing there, the number is likely to be extremely large. Because it has no tax treaty with Mexico, IRS does not receive any income information documents from Mexico making it difficult or frequently impossible to determine whether all income earned there is properly reported on tax returns.

Because IRS does not have a good measure of the extent to which income information documents from tax treaty partners represent the universe of income earned by Americans living or investing in those countries; and because no income information documents come from foreign countries with which we have no tax treaties, it is difficult to estimate the tax loss to the Treasury resulting from these nonfilers or underreporters. Based on a 1980 estimate, IRS believes that the approximately 800,000 paper information documents from tax treaty partners received each year represent total U.S. individual and U.S. business income of $11 billion.[38]

The General Accounting Office testified before the subcommittee that foreign returns involving individual taxpayers aggregated $485 million in 1981, $459 million in 1982, and $536 million in 1984. (These figures reflect income only on processed returns and exclude income reported on the one-third of foreign income returns that are not processed.) If data compiled by the Commerce Department showing total annual foreign source income of $91 billion is correct, the foreign information documents presently received and processed by IRS represent only about 1½ percent of that foreign income.

GAO testified at the hearing on many of the limitations in FIRP program:

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[38] "Improvements Are Needed to Enhance the Effectiveness of the Foreign Information Document Program," Internal Audit Report, Internal Revenue Service, Office of the Assistant Commissioner (Inspection), Reference No. 05276.

> IRS received an average of about 677,000 foreign information returns annually from treaty partners for tax years 1980, 1981 and 1982. The foreign information returns, which vary in form and content on a country-by-country basis, reflect foreign source income earned by U.S. citizens. * * * Some of the information IRS receives from foreign countries * * * is useful. However, about one-third of the information returns cannot be used. Moreover, IRS does not receive information on all foreign-source income earned by U.S. citizens. Although the percentage of processed returns has increased over the last 3 years, IRS remains unable to process a significant portion. For tax year 1982 returns for example, 34 percent of the documents were not processed by IRS. This compares to 48 percent that were not processed in 1980. While these figures show improvement, they indicate that a large percentage of documents are still not processed. Government officials and private sector representatives overseas told us foreign financial institutions are not that concerned with obtaining taxpayer identification numbers because they do not feel it is their responsibility to help administer U.S. tax laws. Further, requiring prospective investors to provide identification numbers was counter to most countries' desire to attract foreign investment. Foreign financial institutions believe that requiring such information would merely cause foreign investors who seek anonymity to take their investments elsewhere.[39]

In addition to the nonreceipt of income information documents from nontax treaty foreign countries and the extremely small number of documents (except for Canada) we receive from our treaty partners, GAO identified two additional limitations on the value and usability of existing FIRP documents: *First*, that many of these documents contain the names of agents or nominees for Americans, and, thus, do not identify the Americans who beneficially own the income. *Second*, that the information returns IRS does receive do not reflect many possible sources of foreign-source income. This is because the foreign tax authorities responsible for transmitting income documents to the IRS receive themselves only reports of types of income taxable under their nation's laws. In France, for example, interest paid on deposits made in certain foreign currencies (such as U.S. dollars and Swiss francs) is exempt from French tax. Since France imposes no tax on these earnings, French financial institutions are not required to report on these accounts to French tax authorities. Without such reporting, this information could not, of course, be reported to the IRS. Moreover, most foreign information returns reflect investment income earned by U.S. citizens, but not salaries or wages earned by Americans while working for foreign firms in foreign countries. In addition, some foreign countries impose no tax or reporting requirements on foreigners' deposits in financial institutions.

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[39] Hearing, pp. 24–25.

Finally, there are "no reporting requirements for either earned or investment income paid to U.S. taxpayers by foreign entities located in foreign countries;"[40] and none for U.S. companies located overseas on income earned by U.S. citizens working for those companies abroad, when the earned income qualifies for the "foreign earned income exclusion" provided by Internal Revenue Code section 911 or is subject to foreign income taxes.[41]

GAO also pointed out that while 33 of the United States' 34 tax treaties (since the subcommittee's hearing, tax treaties with information exchange provisions have been entered into with Aruba, Barbados and Cyprus) contain "exchange of information provisions," only 17 treaty partners provided information returns to IRS for tax year 1982. Some of the tax treaty countries which provided no foreign information returns that year were Belgium, Italy, Korea, the Netherlands Antilles and the Philippines.[42]

The IRS has itself acknowledged the severe limitations in the comprehensiveness, quality and use of the foreign income information returns. Its witnesses testified that:

> * * * we are not able to process many of the income documents simply because they come too late, with some problems that they come beyond the statute or we can't get them into our Information Return Program. Many of them lack addresses. Many of them lack taxpayer identification numbers. We do all we can to perfect those documents when they come in, each and every one of them. But there is going to be a fallout of nonprocessable foreign information documents. And I think our best remedy * * * is to continue our dialogue with treaty partners.[43]

The subcommittee is also concerned over the inevitable impact of an IRS initiated action that will reduce the number of foreign income documents we receive by an average of 50 percent. In 1984, the Service recommended to our tax treaty partners that a minimum dollar floor be established before information on interest, dividend, royalty, etc., income be exchanged between the United States and its treaty partners. Establishment of this tolerance factor, which has been agreed to by 10 of our treaty partners, will substantially reduce the number of foreign income documents sent to IRS. If this tolerance factor had been in effect between 1979 and 1983, 51.5 percent of all foreign documents received by the Service would have been eliminated, as follows:[44]

Year	Percentage of documents reporting income below tolerance level	Percentage of total income represented by these documents
1979	41.7	1.00
1980	51.5	.02
1981	52.0	.02
1982	55.9	4.20

[40] Ibid., p. 113.
[41] Ibid.
[42] Ibid., p. 26.
[43] Ibid., p. 88.
[44] Attachment I to May 15, 1986, letter from IRS to subcommittee Chairman Barnard.

Year	Percentage of documents reporting income below tolerance level	Percentage of total income represented by these documents
1983	56.6	4.90
5-yr average	51.5	2.03

Although the percentage of total income represented by the documents below the tolerance level is small, it is important to note that the identification of nonfiler and underreporters is itself a major component of the information reports program; and that the dollar level of income reported is irrelevant to this component. A tax evader can be identified just as easily by attempting to match a $25 income payment as by a $2,500 payment. It is important to note, additionally, that the percentage of documents that would have been eliminated over the past 5 years under the present tolerance level and the percentage of total income represented by these documents, have been increasing steadily.

Indeed, at least two countries interposed objection to establishment of the tolerance. For example, in an IRS summary of a 1984 Paper on Exchange of Information, Japan opposed the idea for the following stated reasons:

TOLERANCE LEVEL

In their paper, Japan maintains that they do not support the idea of a tolerance level for, primarily, three reasons:

(1) All information is useful regardless of amounts because under Japanese law all income should be added together to arrive at a taxable income,

(2) Even while a document which reports information on a specific individual may be small, similar payments can occur frequently and can be sizeable in total,

NOTE: The Japanese may not understand the tolerance level we established, it is not a per payment tolerance as the Japanese comment seems to imply, but our tolerance level is per document, each which represents the cumulative annual payments to a recipient by a payor.

(3) Obtaining information on income earned in a foreign country is difficult, thus even small amounts provide a valuable lead.

The Japanese comment on nonacceptance of a tolerance level is somewhat surprising. The RSR, Tokyo notified us by cable dated May 15, 1984, after receipt of our letter wherein we stated the U.S. would unilaterally implement a tolerance level, that Japan agreed to our proposal. The cable is unclear whether they agreed to only our implementation of the tolerance level or whether they also agreed to established a similar procedure. Irregardless, the Japanese paper is clear on the issue.

> In their paper, the Japanese state they will, reluctantly, agree to a tolerance level except for payments of interest, dividends and royalties.
>
> The U.S. tolerance level is for all documents which we send out. We cannot implement a per country or per type of income tolerance level which differs therefrom.

The tax authorities of the Caribbean Island nation of Trinidad and Tobago also raised objections to the tolerance.

Another aspect of the tolerance level provides the Commerce, Consumer, and Monetary Affairs Subcommittee with concern: The IRS presently has a tax evasion problem involving U.S. taxpayers who seek to "hide" U.S. source income by having it sent to foreign addresses. By doing so, IRS does not receive a 1099 form from the U.S. payor of the income. The only systematic method currently available to recapture the tax on this income is through use of IRS Forms 5335. This form, which is sent to foreign tax authorities of specific countries, contains the names of recipients of U.S. source income sent to persons in those countries. The foreign tax authorities are asked to review those names to determine whether they are legitimate residents of their country. If they are not, then the foreign tax authority will return their names to IRS and the Service should determine the correct citizenship by the payee. In 1981–1983, 5,680 Forms 5335 were returned to IRS. (This figure may be greatly understated because many countries receiving Forms 5335 fail to properly check the citizenship of the payee.) A few countries, like Switzerland, impose the appropriate U.S. tax on the income and rebate that amount to the U.S. Treasury. In 1985, $96.7 million was remitted by Swiss tax authorities.

By establishing a minimum dollar floor that not only eliminates half of all incoming foreign information documents, but an undeterminable number of outgoing Form 5335 documents as well, the Service will recapture less money and reduce its opportunities to identify American tax evaders who are hiding their U.S. source income by having it sent overseas.

As indicated earlier, payers of foreign source income are under no obligation to report *directly* to IRS income paid to U.S. taxpayers residing overseas or living in the United States. Income information reporting by foreign entities operating in foreign countries and paying income to U.S. citizens is established by the current tax treaty with the United States, if any. The domestic law of each treaty partner governs whether payments to U.S. persons are required to be reported to the foreign tax authorities and the types of payments which are reportable. In any case, foreign paying entities, to the extent they are required to report income, would report it to the foreign tax authority which, in turn, would report it to the Internal Revenue Service.[45]

Information from nontax treaty countries on income paid to Americans is virtually impossible to get. Tax information exchanges depend on mutual benefit. Since IRS is prohibited, absent a treaty, from disclosing information to foreign tax authorities on U.S. source income earned by foreign nationals, the nontax treaty

[45] Ibid., pp. 194, 113.

countries are unwilling to accommodate any IRS requests for information. In some instances, IRS personnel assigned overseas are able to obtain *public* information which may lead to a nonfiler or an underreporter of income.[46]

Finally, in an effort to underscore the severe limitations of FIRP, it is useful to superimpose the dynamics of that system on the *domestic* Information Reports Program (IRP) which will process 95 percent of the 806 million income information documents filed with IRS in 1985.[47] The essential dynamics of FIRP are that foreign income documents are received from only 10 percent of the countries in the world and that only two-thirds of the small number of documents received are actually matched against tax returns. If these limitations were to be applied to the domestic IRP, income documents would be received by IRS from payors of income in only 5 of our 50 States and only two-thirds of those would be processed. Accordingly, instead of processing 765 million domestic information documents, as it presently does, IRS would be matching only 52 million [48]—a dramatic decrease that would wreck the domestic IRP tax compliance effort.

D. THE FOREIGN INFORMATION DOCUMENT PROGRAM REQUIRES SUBSTANTIAL IMPROVEMENT

While those at Treasury and IRS responsible for assessing and collecting taxes have had only limited success in improving the flow of foreign income information documents, the Service's Internal Audit Division (Inspection) has a commendable record of disclosing inadequacies in the FIRP system and recommending solutions. The most recently completed effort in this regard is a report prepared on October 22, 1985, entitled "Improvements Are Needed to Enhance the Effectiveness of the Foreign Information Document Program."[49] This report focuses on a new IRS program, initiated in 1983, to "specially process high dollar foreign information documents." This Foreign Information Document Program (FIDP) supplements the Service's Information Returns Program (IRP) by including documents that could not be processed in the IRP. The Philadelphia Service Center initially processes the documents and forwards those meeting the program criteria to other Service centers and districts to identify unreported income and nonfiling of tax returns."[50]

The internal audit report concluded that the IRS:

> Needs to improve the program to assure that taxpayers underreporting income are identified and to assure that delinquent tax returns are secured. Improvements are needed in the processing procedures and controls; the man-

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[46] Ibid., p. 203.

[47] "1985–1992 Projections, Information and Withholding Documents," IRS Research Division, Document 6961.

[48] Assumes that the 50 States and the territories each furnish the same average number of information documents (806 million÷51=15,800,000); (15,800,000×5=79 million×66 percent=52 million).

[49] "Improvements Are Needed to Enhance the Effectiveness of the Foreign Information Document Program," Internal Revenue Service, Office of the Assistant Commissioner (Inspection), Internal Audit Division, No. 05276.

[50] Internal Audit Report, Digest.

agement information system used to measure program accomplishments; and the extent of compliance by foreign sources in submitting information documents.[51]

The IRS internal auditors identified the following specific problems:

Because of sorting errors and incomplete identification criteria, foreign income information documents totaling income of $300 million to U.S. citizens, were not included in the program and, therefore, could not have been matched against information reported on tax returns.

In connection with the above, the internal auditors reviewed approximately 7 percent of the foreign income information documents received by the Service during 1984 and identified documents for $200 million that met the program criteria but were not included in the program because of sorting errors. The auditors concluded that if the error rate identified by its sample existed throughout the entire population of foreign information documents, 1,500 documents reporting income of $700 million were missed during the sorting process in 1984. The auditors also identified documents reporting additional income of $100 million that were excluded from the program because national procedures did not address several specific situations. If the error rate identified by the sample existed throughout the entire population of documents, the auditors estimated that 600 documents reporting income of $900 million were improperly omitted from the program.

Finally, the internal auditors concluded that based on their limited sample, 2,100 documents representing potential tax deficiencies of $10 million for *individual taxpayers,* were improperly omitted from the FIDP program.[52]

Improvements are required in the processing and perfection of foreign information documents reporting income of U.S. businesses at the Philadelphia Service Center.

Existing controls do not assure that foreign information documents identified for the program are received and accounted for by the various Service centers and districts; and audit trails do not identify lost documents. In this connection, the IRS internal auditors identified a situation in which 25 foreign income information documents reporting income of $1.5 million were lost somewhere between the Philadelphia Service Center IRP Unit and Service centers and districts. Additionally, 32 of 39 Coordinated Examination Program related documents could not be traced to the designated examination groups; and the district office did not receive 6 documents (totaling $3 million) of 22 that were referred from an IRS Service Center.

Service Center Collection Branches either did not initiate or took up to 6 months to initiate taxpayer delinquency investigations based on foreign information documents. The auditors found specifically that while examination branch records at two Service centers indicated that 30 foreign information documents were sent to collection branch for issuance of delinquency investigations, no

[51] Ibid.
[52] Ibid., pp. 2–3.

records could be found to indicate that delinquency investigations had been initiated and the foreign information documents themselves could not be located. In another instance, the internal auditors established that 7 of 15 taxpayers whose names had been identified through foreign information documents had not filed tax returns. Nevertheless, no tax delinquency investigation had been initiated for these 7 taxpayers.[53]

IRS' management information system (Audit Information Management System or AIMS) is not adequate to properly determine the successes or failures of the Foreign Information Document Program. This is because the results reported on the AIMS did not identify tax changes directly attributed to the foreign information documents.[54]

The IRS received no foreign income information documents from 60 percent of the 10 largest banks in four countries with which we have tax treaties. Only 15 of the 40 banks submitted FIDP documents. Because the tax treaties with these four countries provide for routine exchange of information between the United States and the tax treaty country, including the names of U.S. residents receiving interest and investment income from banks in these countries, the absence of such documents raised the most serious questions as to the compliance of these countries and banks with information exchange requirements. The IRS auditors found, however, that there are no procedures designed to determine whether the universe of large foreign banks or other entities in tax treaty countries are complying with the exchange of information provisions.[55]

The summary point to be made here is that while IRS' internal auditors continue to identify weaknesses in the foreign income information program and while the Service demonstrates an interest in responding to these weaknesses, its efforts are piecemeal and fail to focus adequately on the most basic problem: The trickle of "matchable" information documents from our tax treaty partners. In this regard, the Department of the Treasury must assume a substantial portion of blame since it is responsible for negotiating tax treaties and protocols and overseeing their implementation.

E. RECENT DEVELOPMENTS

Since the subcommittee's May 8, 1985, hearing, IRS has undertaken a number of actions designed to strengthen its ability to identify nonfiling and underreporting by Americans living abroad. These steps are described in a recent letter from the IRS to subcommittee Chairman Barnard, a portion of which is reproduced below.

Moreover, in response to the subcommittee's identification of the overseas nonfiler problem, the Senate's version of the Tax Reform Act of 1986 (H.R. 3838) contains provisions (1) requiring applicants for passports to complete an IRS information return before they go overseas. These information returns would provide the traveler's tax ID number and foreign residence; and, (2) authorizing tax withholding on U.S. source pension benefits sent to foreign addresses

[53] Ibid., pp. 6–7.
[54] Ibid., p. 8.
[55] Ibid., p. 9.

absent a certification by the recipient that he or she is not a U.S. person resident overseas. The relevant portions of the Senate Finance Committee Report, is also reproduced hereinafter.

While all these developments, taken together, represent progress in combating the overseas nonfiling and foreign income underreporting problems, much work remains to be done.

COMMISSIONER OF INTERNAL REVENUE,
Washington, DC, May 27, 1986.

Hon. DOUG BARNARD, Jr.,
Chairman, Commerce, Consumer, and Monetary Affairs Subcommittee of the Committee on Government Operations, Rayburn House Office Building, Washington, DC.

DEAR MR. CHAIRMAN: This is in further response to your letter of February 19, 1986, in which you requested information relating to the problem of tax return nonfiling and underreporting by Americans living abroad. Your letter requested information relating to nine points of inquiry. On February 20, Staff Director Peter S. Barash requested information as to a tenth item during a telephone conversation. Our response to items 1, 3a, 4, 6, 7, 8, and 10 was sent on March 13, 1986.

Enclosed are our responses to items 2, 5a, and 9. As previously indicated to Mr. Barash, the responses to items 3b and 5b require special computer extracts which should be available in early July.

With kind regards,

Sincerely,

TOM E. PERSKY,
Assistant to the Commissioner
(Legislative Liaison).

Enclosures.

Item 9

Please set forth as specifically as possible, a description of any action taken by IRS, subsequent to the May 1985 hearing, to address the problems of nonfiling or underreporting by Americans living abroad.

Response

The activities described on pages 178–181 of the hearing record have been continued. In addition, the following activities have also been undertaken.

The Service has initiated a comprehensive study of withholding compliance on the part of employers. One aspect of this study will focus on compliance by U.S employers of "section 911 employees" to assure that they are properly withholding income (where appropriate) and employment taxes as well as properly reporting employee wages. Wage reporting documents submitted by the employers will also be used to identify nonfilers.

The Service has also taken a variety of steps designed to promote compliance by improving the knowledge of taxpayers residing abroad regarding their responsibilities under our tax laws.

A special notice was developed for inclusion with notices mailed to taxpayers with a foreign address under both the Stopfiler Pro-

gram and the Information Returns Program. Notice 754 reads as follows:

U.S. CITIZENS AND RESIDENT ALIENS ABROAD

If you are a U.S. citizen or resident alien living or traveling abroad, you are liable for tax on your worldwide income. The income tax return filing requirements are the same as if you were residing in the United States. You are required to file an income tax return to elect the benefit of the foreign earned income exclusion, foreign tax credit, or foreign housing exclusion. If you do not elect these benefits timely, it may result in their loss. Pension and annuity income, interest, dividend, and other kinds of investment income do not qualify for the foreign earned income exclusion. For more information, please get Internal Revenue Service Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad, which is available at U.S. Embassies and Consulates Worldwide.

A "Filing Facts" tax package stuffer again was included in the tax packages sent to taxpayers with foreign addresses. Stuffer information included a brief summary of significant law changes, filing tips and the availability of tax forms and taxpayer assistance. An annual filing period news release expanded on the stuffer information.

The Armed Forces Information Services (AFIS) published a military Tax Supplement distributed worldwide to 700 military base newspapers and 500 military public affairs officers. It contained a wide range of tax and filing information provided by IRS, much of it geared specifically to the military. The Stars and Stripes newspaper gave prominent coverage to a news release alerting personnel employed in nonappropriated funds activities (such as commissaries) not to claim the Section 911 exclusion. The AFIS also transmitted the tax clinic originally produced and telecast in the U.S. by the Public Broadcasting System. In addition, the AFIS daily radio news program broadcast a 20-minute filing period feature prepared by IRS for Armed Forces Digest.

Other news releases distributed to appropriate overseas media outlets covered: amendments to the Section 911 regulations which established deadlines to file returns claiming the foreign earned income exclusion for 1982 and 1983; the annual overseas taxpayer assistance tours; amendments to the Foreign Investment in Real Property Tax Act which affected Canadians beginning in 1986; and a description of the Problem Resolution Program.

In cooperation with the State Department's Office of Consumer Affairs, the IRS is arranging for copies of its Publication 593, Income Tax Benefits for U.S. Citizens Who Go Overseas, to be stocked and displayed in all passport offices in the U.S.

EXCERPT FROM COMMITTEE ON FINANCE SENATE REPORT NO. 99-313, TAX REFORM ACT OF 1986, H.R. 3838

4. COMPLIANCE PROVISIONS APPLICABLE TO U.S. PERSONS RESIDENT ABROAD; GREEN CARD HOLDERS (SEC. 986(a) AND (b) OF THE BILL AND SEC. 3405 AND NEW SEC. 6039E OF THE CODE)

Present law

U.S. citizens who live abroad are required to file U.S. tax returns and pay U.S. tax on their worldwide income, just as they are required to do when they live in the United States. In addition, it is possible for an alien to be considered a resident of the United States even during periods when he is living outside of the United States; such persons therefore continue to have the same duty to file and pay tax as any other U.S. citizen or resident. Certain special rules apply to U.S. citizens and residents who live abroad, such as section 911's limited exclusion of foreign earned income. In addition, credits against tax may be available to such persons for foreign taxes paid on their foreign source income.

Reasons for change

Failure to file

The committee is concerned that a substantial percentage of U.S. persons resident overseas may fail to comply with the requirement that they file U.S. tax returns. The General Accounting Office has gathered evidence suggesting that the percentage of taxpayers who fail to file returns is substantially higher among Americans living abroad than it is among those resident in the United States. Such nonfilers may consist of two general types. First, there are the negligent nonfilers: those who assume that their residence overseas exempts them from U.S. tax, and those who think that they need not file if section 911 and/or foreign tax credits eliminate their U.S. tax liability. Second, there are fraudulent nonfilers, those who know their duty to pay U.S. tax but do not fulfill it. The committee believes that both of these cases present significant compliance problems that must be addressed.

With respect to the first case, the negligent nonfiler, the committee emphasizes that it is important that a return be filed even by those who believe their U.S. tax liability to be zero (as long as their gross income exceeds the return filing threshold). The Internal Revenue Service should have the opportunity to determine that taxpayers with significant gross income have properly applied the provisions relevant to the determination of their liability. Since the foreign tax credit is among the most difficult provisions of the Code, it is particularly important that the Service have an opportunity to review the application of those provisions by citizens and residents abroad. In addition, ensuring regular filing by such persons may help prevent inadvertent nonfilers from becoming habitual and fraudulent nonfilers.

With respect to the second case, the fraudulent nonfiler, it is obviously important to the integrity of the Federal tax system that the government have the ability to detect and bring to justice those who evade their share of the tax burden.

The committee believes that both cases should be addressed by requiring that an Internal Revenue Service information return be completed in conjunction with the processing of applications for passports in the case of citizens, and permanent resident visas ("green cards") in the case of resident aliens. Such a requirement would serve to notify inadvertent nonfilers of their continuing duty to file a U.S. tax return. Presumably a substantial number of such nonfilers would respond by filing their returns. In addition, of course, such a requirement would provide the IRS with information that would enable it to contact nonfilers and, if necessary, initiate collection actions. The committee recognizes that the present ten-year validity of passports means that such information would only be collected at infrequent intervals. Nevertheless, the committee believes that the occasional provision of such information would represent a substantial improvement over present law, which provides the IRS with far fewer opportunities to obtain information concerning U.S. taxpayers living abroad. U.S. persons would no longer be able to move overseas and drop out of the U.S. tax system entirely; occasional reporting in conjunction with renewal applications will ensure ongoing opportunities to locate such persons.

Collection of tax

Even when overseas nonfilers are identified, enforcement is often difficult because the IRS is rarely able to collect tax in a foreign country. The Service must instead attempt to locate assets within the United States which can be seized to satisfy a nonfiler's tax liability; if the nonfiler has taken most of his assets abroad, collection may be impossible.

Pension payments are generally subject to withholding only at the taxpayer's election. Such payments often represent a substantial stream of income to U.S. persons resident overseas who are relatively likely to owe U.S. tax on such income (because the section 911 exclusion does not apply to it). Therefore, the committee believes that it will be appropriate to require withholding with respect to pension payments to persons with foreign addresses absent a showing that withholding is not required.

Explanation of provisions

Failure to file

The bill provides that an IRS information return must be filed in conjunction with a citizen's passport application, and with a resident alien's green card application. These returns must provide the individual's taxpayer identification number, any foreign residence of a passport applicant, information with respect to whether a green card applicant has been required to file a tax return, and such information as the Secretary may require. In addition, the committee expects that the instructions accompanying these information returns will clearly explain the filing requirements applicable to citizens and residents living abroad. A new penalty of $50 will generally apply with respect to a failure to file the required return, in addition to any other applicable penalties (such as the criminal penalties provided in section 7203 for willful failures to

comply with the reporting and other requirements of the Code). Any U.S. agency collecting these returns is to provide them to the Secretary.

Collection of tax

The bill provides that pension benefits (and similar payments) will be subject to withholding under section 3405 if delivered outside the United States. The election generally available under section 3405 to forgo withholding will not be available in such cases. This automatic withholding will not apply if the recipient certifies to the payor that he or she is not a U.S. person resident overseas (or a tax avoidance expatriate (sec. 877)). The committee expects that such a certification may appropriately be provided for by modifying forms prescribed by the Secretary for the use of payees making the election to forgo withholding under section 3405.

Effective date

The reporting requirement applies to passport and green card applications filed after 1986. The withholding requirement applies to payments made after December 31, 1986.

Revenue effect

The provisions are estimated to increase fiscal year budget receipts by less than $5 million per year.

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